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TAGS: ECON EFIN EINV ETRD KS
SUBJECT: Visit of San Francisco Federal Reserve Bank President
Janet Yellen, November 17-19, 2008

¶1. (U) This cable is sensitive but unclassified and is not/not intended for internet distribution.

¶2. (SBU) Summary: President of the San Francisco Federal Reserve Bank, Janet Yellen, met with a wide range of ROKG financial authorities, market actors, and economists during her November 17-19 visit to Seoul. Yellen led an open exchange of information and ideas regarding the impact of global financial turmoil on both countries. Korean financial authorities and market actors praised the timing of the Federal Reserve's October 29 announcement of its USD 30 billion swap arrangement with Korea, crediting the move with ending panic and bringing stability to Korean financial markets. The global credit crunch and the continuing selling of Korean equities by foreign investors were cited as the two biggest factors in the continuing pressure on the Korean won. Technical factors such as the gradual unwinding of currency-risk hedging positions were also cited as contributing to the won's weakness.

¶3. (SBU) Summary continued: All interlocutors agreed that the Korean economy has essentially absorbed the shockwave of global financial turmoil and concern has now shifted to the impacts of the global economic slowdown and continuing credit crunch on the broader economy. Given Korea's large trade and financial exposure to the global economy, the Korean economy is expected to experience lower growth as exports slow and domestic demand remains weak. All agreed that deterioration can be expected among weaker SMEs; the financial authorities noted that they had already begun to encourage restructuring within the construction and shipbuilding sectors. Officials pointed to the significant room Korea has for additional monetary and fiscal stimulation. End Summary.

¶4. (SBU) During her November 17-19 visit to Seoul, San Francisco Federal Reserve Bank President Janet Yellen met with a wide range of ROKG financial authorities, market actors, and economists to discuss developments in the impact on Korea of global financial turmoil. Yellen was accompanied by Federal Reserve Board of San Francisco Group Vice President for Banking Supervision and Regulation Teresa Curran and Federal Reserve Board of San Francisco Group Vice President for Economic Research Reuven Glick. Yellen began the schedule with a call on the Ambassador.

¶5. (SBU) The financial authority officials that Yellen met included: Bank of Korea Governor Lee Seong-tae; BOK Monetary Policy Committee Members Kim Dae-sik, Choi Do-soung, and Kang Myung-hun; Vice

Chairman of the Financial Services Commission Rhee Chang-young; and, Financial Supervisory Service Governor Kim Jong Chang. The leading economic and financial sector thinkers included former Prime Minister Han Duck-soo, Chairman of the National Strategy Institute Yang Soo-kil, President of the Seoul Financial Forum Kim Kihwan, Seoul National University professor Min Sang-kee, and Korea University professor Park Yung-chul. Among the market actors were President of Kang and Company Kang (Thomas) Chan-soo, Vice President of Hana Financial Holding Kim Eunice, and JP Morgan Managing Director Lee Sung-hee. Economists included Lim Jiwon of JP Morgan, President of the Korea Development Institute Hyun Jung Taik, Moon Ki-hoon of Good Morning Shinhan Securities, Kwon Goo-hoon of Goldman Sachs, and Yang Ho-chul of Margan Stanley.

Banking Sector and Currency

¶6. (SBU) Korean interlocutors described the suddenness and strength of the dollar liquidity squeeze that hit Korean banks and the broader economy in September and October following the onset of the credit freeze in the United States after the collapse of Lehman Brothers. Most acknowledged that some ROKG and private sector financial decisions that seemed reasonable at the time actually exacerbated the vulnerability of Korea's economy to the global credit crunch. Some of these decisions included the Korean end of the Japanese yen carry trade, ROKG encouragement of outbound investment, duration mismatches in currency hedging positions, and risky or excessive hedging positions. Others factors included Korea's recent current account deficit and accumulation of short-term debt, both of which were driven by commodity price spikes. Professor Min Sang-kee noted that foreign equity investors

had begun leaving the market and repatriating their hard currencies two years ago. This was obscured by credit inflows (short-term debt) that accelerated in the same timeframe.

¶7. (SBU) Bankers and market actors uniformly stressed the decisive impact the October 29 Fed-BOK currency swap arrangement has had in stabilizing Korean financial markets by eliminating fear. Bankers and officials described the overall health of the Korean banking sector as good. While banks are engaged in corporate lending and a full range of other financial services, bankers pointed out that the banks' biggest assets are loans to households -- both mortgage and credit card debt. They noted that even though real estate prices are declining, conservative loan-to-value ratio rules (40-60 percent) would prevent the emergence of a Korean version of the U.S. sub-prime loan problem. Short-term (3-year) housing loans are gradually being extended to longer durations and the ROKG is working to prevent variable interest rates from climbing too high. Nonetheless, there was broad agreement that banks will focus on strengthening capital as some assets on their balance sheets sour.

¶8. (SBU) JP Morgan economist Jiwon Lim argued that relatively few banks are currently overexposed to bad loans. Lim, who had been the first economist to call the won overvalued in 2008, said she does not see a second wave of currency crisis hitting the banking sector or the economy. Dollar supply will remain tight and keep the won under pressure, but banks are seeing increases in deposits of both won and dollars (unlike the situation in many other markets). The continuing unwinding of earlier hedging positions will keep dollar demand strong for many months. Foreign banks have reduced dollar lending as home offices now strictly enforce stiffer collateral requirements. Many banks have been hesitant to sign up for ROKG foreign debt guarantees because of the conditions in the government-required MOUs, e.g., reducing executive compensation. The won-dollar exchange rate should begin to reset with a strengthening of the won as the global credit crunch begins to ease, according to Lim. Another factor in favor of a stronger won will be the movement of the current account balance into the black and growing net export revenues over the coming months.

Impact on the Broader Economy

¶9. (SBU) Korean firms, particularly larger exporters and chaebols,

had learned the lessons of the Asian Financial Crisis and are not overleveraged, according to financial authorities. Corporate leverage routinely reached 400 percent in 1997 but was currently less than 100 percent on average. Despite this careful positioning, many of these firms are being affected by the credit crunch by scarcity of dollar lending, falling equity values and a very thin bond market. Market actors suggested that one problem is the mismatch between Korea's well developed export industries and its still developing financial markets.

¶10. (SBU) Economists continue to worry that despite considerable diversification by region and product, Korean exports may be hit hard if global growth falls as much as some analysts have predicted. Korea's economy is heavily exposed to international demand both through exports and imports. The shipbuilding industry will be watched especially carefully because of its huge hard currency earnings in recent years. Some interlocutors suggested that in the longer term the substantial depreciation of the Korean won will have a payoff in export earnings as Korean exports become more competitive vis-`-vis China, and particularly Japan. One banker noted that the won was down by approximately 50 percent versus the yen in the last few months. Others worried that this competitiveness could produce an increase in market share for Korean vehicles in the U.S. market at a time when U.S. deliberations on possible ratification of the KORUS Free Trade Agreement were most sensitive to such a development. Still others argued that in the short term, trade adjustments will tend to come with respect to imports (through the price mechanism) rather than exports, which take longer to respond to new price and other market conditions.

¶11. (SBU) Economists pointed to the Korean construction sector as a continuing source of weakness in a generally sluggish environment

for domestic demand. The earlier excess housing construction needs to be worked through -- one expert estimated total lending to construction firms at over USD 100 billion -- and there is unlikely to be significant new demand for construction domestically before the ROKG's stimulus package is implemented in 2009. There was also broad agreement that many SMEs will need restructuring -- in construction and even in the lower tiers of the shipbuilding industry. FSS Governor Kim Jong Chang noted that the delinquency rate on SME loans was still only 1.5 percent, but he acknowledged that the rate was still rising.

Economic Policy/Regulatory Actions

¶12. (SBU) Former Prime Minister Han Duck-soo described the Federal Reserve's October 29 action to extend the USD 30 billion swap line to Korea as "very crucial" and noted that this action had eliminated the sense of panic that had pervaded Korean markets until that point. He noted that the ROKG had faced a psychological barrier, a fear of actually using the considerable (USD 212 billion as of October 31) foreign exchange reserves to protect the financial system. He ascribed this to the extreme nature of the current financial turmoil and the worry about how much foreign currency reserves were enough. Korea's experience in the Asian Financial Crisis 11 years ago -- running out of foreign exchange reserves and requiring an IMF program to prevent sovereign default -- also made financial authorities cautious about using the foreign exchange reserves. Professor Min pined that if the credit crunch continued over a sufficiently long term, Korea would not have sufficient foreign exchange reserves to weather the global financial storm.

¶13. (SBU) Economists and strategists shared largely similar views regarding a slow start to the ROKG response to the crisis. Many saw the government as responding strongly since mid-October (and implicitly not so strongly before) with a broad array of measures. They called for the government to take additional bold measures to encourage restructuring in weak industries. While fiscal stimulus could buy time for this restructuring, it cannot put it off indefinitely. Former PM Han noted that SMEs account for around 80 percent of employment and that the government will need to expand the targeted lending that it has initiated through the state policy banks such as the Industrial Bank of Korea.

Government Policy Perspectives

¶14. (SBU) ROKG financial authorities were quick to explain that with Bank of Korea lending rates set at 4 percent, a budget surplus, and over USD 200 billion in foreign exchange reserves, the ROKG still has significant room for additional monetary and fiscal stimulation of the economy. Most dismissed the possibility of negative repercussions for the current account balance from fiscal stimulation. The choice to stimulate the construction sector generates a low marginal propensity to import. The more-or-less universal choice by governments around the globe to undertake economic stimulation measures should neutralize to some extent effects on imports and exports.

¶15. (SBU) FSC Vice Chairman Rhee described the now-familiar ROKG view of ways in which the foreign media got the situation in Korea wrong -- misunderstanding the actual status of short-term loans (a large proportion of which reflect borrowing by foreign banks), a sudden panic regarding exports (which are diversified by region and sector), and an unfair downgrading of Korean banks (which generally remain in good shape). He also cited changes made by successive ROK governments had made changes that that strengthened government and financial institutions and left the country much better prepared for times of economic uncertainty. That said, he acknowledged something of what he called the "stigma effect," in which people automatically tend to view the Korean economy through the prism of what happened in 1997/98.

¶16. (SBU) Rhee continued that the government has reviewed the health of SMEs burdened with the especially pernicious Knock-in Knock-out (KIKO) currency hedging contracts and that fewer than 20 are in deep

trouble. He stressed that Korean banks are safe and are still receiving a strong deposit flow from Korean citizens who seek the safety of guaranteed deposits. Rhee estimated that foreign investors had pulled USD 30-40 billion out of Korea but claimed the rate of withdrawal was decelerating. He also noted that banks were beginning to issue subordinate debt to raise capital and ensure they remained within the 10 percent BIS end-of-year ratio. Rhee closed by noting the utility of credit guarantee agencies during the recovery from the Asian Financial Crisis and the ROKG's current use of them.

¶17. (SBU) FSS Governor Kim stated that banks did not currently have sufficient capital to absorb the expected souring of assets. He too noted that the banks are working to issue subordinated debt but believed that more would be necessary. He anticipated that ROKG financial authorities would develop a method to inject capital directly into banks. A specific method had not yet been selected and would likely wait for an evaluation of banks' own efforts to raise capital. Asked about the impact of government encouragement of bank lending to SMEs on the quality of bank assets, Governor Kim said the ROKG asks the banks to support only those SMEs that are sound with temporary liquidity problems and leaves the determination of soundness to the banks.

¶18. (SBU) Several experts asked Yellen how financial prudential regulations for banks and other financial institutions could be expected to withstand the current extremes of the current global financial turmoil. Yellen stressed that in modeling scenarios, U.S. financial authorities had never projected out conditions as bad those currently prevailing.

Expectations for 2009

¶19. (SBU) Most of the economists still anticipate Korean GDP growth in 2009 will be between 3 and 4 percent, reflecting the positive impact of the ROKG's substantial 2009 stimulus plan. A few economic forecasts, however, have suggested growth could be one percent or even less. Most non-ROKG interlocutors suggested that the government should work harder to lower expectations for future growth (and to formally abandon the campaign goal set a year ago by

then Presidential candidate Lee Myung-bak of GDP growth of 7 percent).

¶20. (SBU) Regarding global steps to address the financial turbulence, most interlocutors agreed that the G20 was a good choice of forum - not least because of Korea's participation -- and that the gathering went as far as possible under the circumstances. All agreed that global cooperation had been very strong so far and remains important in ensuring that countries maintain a positive policy response (and eschew unproductive or beggar-thy-neighbor approaches).

STEPHENS